No. 11000

In the United States Circuit Court of Appeals

For the Ninth Circuit

RUBY M. BROWN,

Appellant,

vs.

NEW YORK LIFE INSURANCE COMPANY,

Defendant,

FEDERAL DEPOSIT INSURANCE CORPORATION,

Appellee.

APPELLANT'S REPLY BRIEF

Upon Appeal from the District Court of the United States for the District of Oregon.

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Upon Appeal from the District Court of the United States for the District of Oregon.

APPELLEE'S "STATEMENT OF THE CASE"

The greater part of Appellee's "Statement of the Case" is argument presenting its theory of the law as applied to the facts.

The objectionable part of the "Statement" commences with the sentence starting at the bottom of page 2 and continues on to the heading "Proceedings Below" on page 5.

We, of course, concede that F.D.I.C. is entitled to argue its theory of the law as applied to the facts — but such argument does not belong in the "Statement of the Case".

Obviously, if the agreed facts contained the conclusions which Appellee sets forth in its "Statement", there would be nothing for this court to decide.

The governing facts — correctly stated — are all agreed upon and are contained in the Pretrial Order.[1]

APPELLEE'S "ARGUMENT AS TO SPECIFICATION OF ERROR I"

In its argument under this heading, F.D.I.C. concedes that the principles announced by this court in *American Surety Co. v. Bank of California*[2] are correct and that "American Surety Co. v. Bank of California, supra, is good law * * *."[3]

F.D.I.C. attempts to avoid the fatal effect of the holding in that case upon its claim to the insurance proceeds in this action by arguing that the facts of this case are so different that the rule stated in *American Surety Co. v. Bank of California* is inapplicable.

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1 R. 3-23.

2 44 F. Supp. 81; affirmed 133 F. (2d) 160.

3 Appellee's Brief p. 15.

As "distinguishing features", F.D.I.C. asserts:

(1) Brown stole the Bank's funds not the depositors' and the Bank alone acquired a claim against Brown.

(2) The depositors acquired no claim against Brown and did not assign any claim to F.D.I.C.

(3) The foundation of its claim in this action is the Bank's claim against Brown, which was assigned to it.

(4) F.D.I.C. did not insure against Brown's dishonesty — it insured the Bank's deposits to the extent of $5,000.00 for each depositor.

(5) F.D.I.C. purchased the Bank's assets and it did not thereby discharge a debt. The purchase was for value.

(6) No personal judgment is sought against Appellant and she will suffer no loss.

(7) The equities are in favor of F.D.I.C. as against Appellant.

These alleged "distinguishing features" are practically the same as those urged by F.D.I.C. in the trial court. Its contentions in the court below are stated and answered in our opening brief at pages 11 to 14, inclusive.

We will now discuss briefly the alleged "distinguishing features" now asserted.

Brown stole the Bank's funds not the depositors' and the Bank alone acquired a claim against Brown.

Because F.D.I.C. did not indicate in the trial court whether it was claiming that the stolen funds were depositors' funds or the Bank's funds, we assumed and analyzed both positions. Now that F.D.I.C. has elected to contend that the Bank's funds were stolen by Brown, a simplification of our diagram and argument is possible, which makes more certain the applicability to the facts of this case of the rule announced in *American Surety Co. v. Bank of California.*

F.D.I.C. does not deny that it is an insurer for a consideration. It proclaims that it insured the deposits of the Bank.[4] It concedes that under the "purchase" arrangement it "protected the depositors"[5] by paying out the difference between the remaining acceptable assets of the Bank and its total deposit liability.[6] In other words, shortages in the Bank's assets were restored with cash supplied by F.D.I.C.[7]

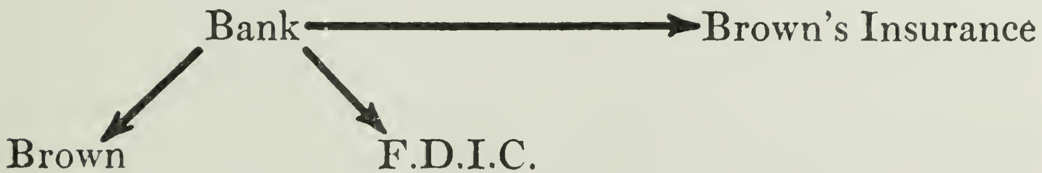
The diagram and explanation of the holding in *American Surety Co. v. Bank of California* is as follows:

Crowe, whose fidelity was insured by Interior with American Surety, wrongfully abstracted money from In-

[4] Appellee's Brief p. 7.
[5] Appellee's Brief p. 7.
[6] Appellee's Brief p. 8.
[7] Appellee's Brief p. 11.

terior's account under circumstances making the Bank of California liable for the loss. Interior therefore had a claim for reimbursement against Crowe, American Surety and the Bank. It called upon the Surety Company to respond and it did so, taking an assignment of Interior's claim against the Bank. *Held* payment by the insurer extinguished the debt and it could not recover over against the Bank either by virtue of the assignment or subrogation.

The simplified diagram and explanation of the facts in this case, based on F.D.I.C.'s position that Bank funds were stolen by Brown, is as follows:



Brown wrongfully abstracted money from the Bank under circumstances making F.D.I.C. liable for the loss (to the extent of $5,000.00 for each depositor). The Bank therefore had a claim against Brown, a claim against F.D.I.C., and, assuming stolen money could be traced into the insurance premiums, a claim against Brown's insurance. The Bank called upon F.D.I.C. to respond and it did so, taking an assignment of all of the Bank's assets which included its claim-over against Brown's insurance.

It must be held that payment by the insurer extinguished the debt so that it does not hold by reason of assignment or subrogation any rights which the Bank might have had

over against Brown's insurance but for its payment of the claim.

The paragraph in our opening brief at page 9, which F.D.I.C. singles out for criticism, may likewise be rephrased in view of F.D.I.C.'s election to contend that Brown stole the Bank's funds and not the depositors, as follows:

> "In our case here, it is claimed that Brown wrongfully abstracted money from the Bank under circumstances making F.D.I.C. liable to the extent of $5,000.00 for each depositor. F.D.I.C. has responded and has made good the shortages in the depositors' accounts, taking an assignment of all the Bank's assets, including the Bank's right to follow stolen funds into the insurance proceeds. In this action, F.D.I.C. is attempting to assert the remedy which the Bank had to reach the proceeds of the policies on the life of the wrongdoer, assuming stolen funds can be traced into the premiums, and under the doctrine of the American Surety Co. case it must be held that when F.D.I.C. made good the shortages in the depositors' accounts that it merely did what it undertook to do for a consideration and therefore its payment discharged the debt and it can not aid its position or change the consequences by taking an assignment or anything else."

F.D.I.C. can no more reimburse itself by attempting to follow stolen funds into the premiums than American Surety Co. could reimburse itself by asserting Interior's claims against the Bank of California. While Interior, in the *American Surety Co.* case and the Bank in this case had an election whether to proceed against any one of three sources for reimbursement, when Interior and the Bank

called upon the insurer and it responded it could not, by virtue of an assignment from its insured, pursue any of the other remedies available to its insured prior to its exercise of its election.

American Surety Co. v. Bank of California cannot be distinguished and this court's ruling must be that Appellant is entitled to the proceeds of the policies.

The depositors acquired no claim against Brown and did not assign any claim to F.D.I.C.

In making this argument, F.D.I.C. has completely ignored the issue of law framed by the pretrial order which is the basis of this Specification of Error. The issue of law is:[8]

> "Whether Federal Deposit Insurance Corporation succeeded to or became subrogated to the Bank's rights, if any, as against the proceeds of the insurance policies upon the life of Edward N. Brown."

If F.D.I.C. had taken the position in the trial court and here that the funds stolen by Brown were the depositors' and not the Bank's, then it would have to show an assignment of the depositors' claims to follow the stolen funds into the insurance proceeds. Since F.D.I.C. now claims that what Brown stole was Bank funds and that it stands in the position of the Bank as assignee of its assets, it is apparent that the depositors had no claim against Brown since their money was not stolen by him and they would therefore have no claim against Brown, against F.D.I.C., as the insurer, or against the proceeds of Brown's insurance.

[8] R. 26.

The Bank was the insured — it had a claim against Brown, against F.D.I.C., as the insurer, and against the proceeds of Brown's insurance, assuming stolen funds could be traced into the premiums.

This asserted "distinguishing feature" therefore disappears.

The foundation of its claim in this action is the Bank's claim against Brown, which was assigned to it.

F.D.I.C. is clearly wrong in its suggestion that the foundation of its claim in this proceeding is the Bank's claim against Brown, which it claims to hold as assignee. The fact is that the foundation of F.D.I.C.'s claim in this proceeding is the Bank's rights to follow stolen funds into the insurance proceeds which it is claimed the Bank assigned with all its other unacceptable assets to F.D.I.C. As has already been pointed out, when Brown died and the shortage was discovered, the Bank had three claims for reimbursement, any one of which it was entitled to follow. The first was the claim against Brown, which could be followed by making a claim against his Estate. The second was the claim against the insurer, F.D.I.C., to require it to respond on its obligation to restore the stolen funds to the extent of $5,000.00 for each depositor. The third was the right to trace stolen funds into the proceeds of Brown's insurance.

The Bank elected to call upon the insurer, F.D.I.C., and it responded, taking an assignment of the Bank's assets.

F.D.I.C. is not asserting in this action the Bank's claim against Brown's Estate but is attempting to assert the

third remedy which the Bank had to follow stolen funds into the insurance proceeds.

Under the doctrine of *American Surety Co. v. Bank of California,* the debt was extinguished when F.D.I.C. responded on its obligation and it cannot assert, by way of assignment, the right which the Bank had to follow stolen funds into the insurance proceeds.

Obviously the Bank's claim against Brown's Estate is not the foundation of F.D.I.C.'s claim in this proceeding and it is wholly erroneous in so asserting. In any event, the Bank having made the election to call on the insurer, no other remedies are open to it or to F.D.I.C., as its assignee.

F.D.I.C. did not insure against Brown's dishonesty—it insured the Bank's deposits to the extent of $5,000.00 for each depositor.

While it is true that in the *American Surety Co.* case the insurer merely undertook to make good any losses by reason of the infidelity of Interior's employee and while F.D.I.C. insured the Bank's deposits to the extent of $5,000.00 for each depositor, the event which caused the loss in both instances was the infidelity of the insured's employee.

The fact that F.D.I.C.'s obligation was broader than American Surety Co.'s does not furnish a basis for distinguishing the case, especially in view of the fact that both insurers responded because of an identical loss — theft by the insured's employee.

F.D.I.C., by so responding, can acquire no greater rights than American Surety Co. did and it must be held that payment by F.D.I.C., as the insurer, extinguished the debt and left it no right to reimburse itself by attempting to follow, by virtue of an assignment, any of the other remedies which the insured had prior to payment by the insurer.

F.D.I.C. purchased the Bank's assets and it did not thereby discharge a debt. The purchase was for value.

From time immemorial insurers have endeavored to acquire their insured's right to follow other claims for reimbursement, so as to reduce their loss.

In the *American Surety Co.* case the insurer took an assignment of Interior's right to recover against the Bank of California and attempted to assert it to reduce its loss.

In this case, F.D.I.C. attempted to invest itself *by assignment* with the right which the Bank had, prior to calling upon F.D.I.C. to respond, to reimburse itself by following stolen funds into the insurance proceeds.

Since F.D.I.C. is admittedly an insurer for a consideration, since it admittedly responded and paid the loss, it merely did what it had contracted to do. It cannot reduce its loss by attempting to assert any other remedy which the Bank, as its insured, had to reimburse itself prior to calling upon F.D.I.C. to respond.

While F.D.I.C. claims that it "purchased" the unacceptable assets of the Bank, it is interesting to note that the "purchase price" was measured by the difference between

the remaining acceptable assets of the Bank and its total deposit liabilities, so that by "purchasing" it merely replaced the loss.

It is interesting to note further that the "purchase price" did not go to the Bank but went to The United States National Bank, which assumed the deposit liabilities of the Bank.

It is interesting to note, in addition, that F.D.I.C. compelled the Bank to give it a note for $800,000.00[9] so that instead of the Bank receiving anything in the so-called "purchase", it turned over its unacceptable assets to F.D.I.C., which gave the "purchase price" to The United States National Bank and the Bank was compelled to give its note to offset the so-called "purchase price" which it didn't even receive!

Obviously, the so-called "purchase" was conceived for the sole purpose of attempting to void the effect of *American Surety Co. v. Bank of California,* which F.D.I.C. now proclaims is good law.

When the shortage was discovered, F.D.I.C. was obligated to respond under its contract, it did respond, it cannot aid its position by claiming that it "purchased" the unacceptable assets of the Bank. It is admittedly attempting to assert the Bank's claim to follow stolen funds into the insurance proceeds by virtue of an assignment from the Bank.

The assignment can help it no more than the assign-

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[9] R. 111.

ment of Interior's claim against the Bank of California to American Surety Co. aided the surety company in *American Surety Co. v. Bank of California.*

No personal judgment is sought against Appellant and she will suffer no loss.

F.D.I.C. attempts to distinguish this case from *American Surety Co. v. Bank of California* by claiming that no personal judgment is sought against Appellant and that she will suffer no loss. It is inconceivable to us that F.D.I.C. can seriously contend that Appellant will suffer no loss if she is deprived, in this proceeding, of the proceeds of the insurance policies in which she was named the beneficiary. While it is true that no personal judgment is sought against Appellant, that is because the fund to which she is entitled under the contracts of insurance is being held in the registry of the court to abide the final decision herein. Had the proceeds of the policies been paid to Appellant prior to the institution of this proceeding, F.D.I.C. would have been seeking a personal judgment against Appellant requiring her to turn over to it the money which she received.

Obviously, this alleged "distinguishing feature" has no merit in it.

The equities are in favor of F.D.I.C. as against Appellant.

The language of this court in *American Surety Co. v. Bank of California* answers this sugested distinguishing feature better than any argument we can supply. It is as follows:[10]

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[10] 133 F. (2d), pp. 162, 163 and 164.

"The right of subrogation is a creature of equity, applicable where one person is required to pay a debt for which another is primarily responsible, and which the latter should in equity discharge. In theory one person is substituted to the claim of another, but only when the equities as between the parties preponderate in favor of the plaintiff. * * * A surety may pursue the independent right of action of the original creditor against a third person, *but it must appear that said third person participated in the wrongful act involved or that he was negligent,* for the right to recover from a third person is merely conditional in contrast to the right to recover from the principal which is absolute. The equities of the one asking for subrogation must be superior to those of his adversary. If the equities are equal or if the defendant has the greater equity, subrogation will not be applied to shift the loss.

* * *

"In the instant case the surety contracts are confined to Insurers and Interior. Any right of recovery against third parties for money paid Interior by Insurers under the contracts must rest solely upon a weighing of the equities as between the third parties and Insurers. *Such equities generally depend upon participation in wrongdoing, negligence, or knowledge,* although we do not mean to say that these expressions cover the gamut of equities which may or should be considered.

* * *

"In all of the situations outlined defendants had actual knowledge of facts sufficient to put them on notice of the wrongdoing and in a way, therefore, were implicated in the wrong done. * * * No indication is found that Bank knew any facts which would suggest the fraud of an employee of its depositor. Insurers, on the other hand, expressly contracted to se-

> cure Interior against losses caused by a dishonest employee, such as Crowe. They accepted the responsibility for such losses for a compensation, the premiums paid to them, which they have retained. Both they and Bank are innocent of any wrongdoing, although all were liable to Interior (under assumption of Bank's liability to Interior) on the basis of independent contract obligations—the implied contract of Bank to pay only to those entitled, and the contracts of Insurers to indemnify against losses caused by a defalcating employee. Since Insurers expressly, voluntarily and for a compensation guaranteed against loss in the exact situation involved, the equity in the situation cannot lie in favor of Insurers and against Bank for the payment made."

It is conceded in this case that Appellant knew nothing of her son's wrongdoing. She was not negligent in any way. There is no possible way that F.D.I.C. can claim that the equities are in its favor as against her.

The *American Surety Co.* case is controlling and it must be held that F.D.I.C. has no claim to the proceeds of the policies. A judgment awarding all of the proceeds to Appellant must enter.

APPELLEE'S ARGUMENT UNDER SPECIFICATION OF ERROR II

In an effort to sustain the trial court's opinion and to answer the authorities and argument which we have presented under this Specification of Error, F.D.I.C. contends. (1) that the burden of proving that the premiums were paid with Brown's own funds is upon Appellant, (2) that automatic setoff operated to extinguish Brown's

own funds in his accounts when the premium checks cleared, and (3) Federal Public Policy estops Appellant from claiming the funds.

THE BURDEN OF PROOF

Only two cases are relied upon to place the burden of proof upon Appellant. They are *McConnell v. Henochsberg,* 11 Tenn. Appeals 176, and *Meyers v. Baylor University*. 6 S. W. (2d) 393. In our opening brief, we have already demonstrated conclusively that neither case supports F.D.I.C.'s position in this regard and, since the authorities cited in our opening brief have not been answered or distinguished, it must be held that the burden of proof was upon F.D.I.C.

F.D.I.C. argues for, but fails to support with authority, its theory that Brown's death does not dispense with the rule requiring the wrongdoer to separate the fund. As we pointed out in our opening brief, not one single case exists which invokes a presumption in favor of a beneficiary attempting to trace trust funds where the trustee or wrongdoer is dead.

Since in this case the items in Brown's accounts when the premium checks cleared are agreed upon and *since not one single cent of stolen funds have been traced into the bank accounts at any time,* much less when the premium checks cleared, the situation is exactly the same as if Brown were alive and he had explained that the items in his accounts when the checks cleared were his own funds. Such a showing would require a finding in Appellant's favor and

the facts having been stipulated and there being no evidence that even one cent of embezzled funds was placed in these bank accounts, Appellant must be awarded the proceeds of the policies.

In argument, F.D.I.C. suggests that the lands which Brown purchased, his cattle and grain operations and the bank accounts concerned were conducted and maintained with stolen funds *yet not one cent of stolen money is traced into the real property he admittedly owned, into the steer or grain accounts or into the bank accounts involved.* The fact that F.D.I.C. is unable to trace any of the stolen money into any of Brown's assets or accounts is conclusive proof that they did not so originate and that the admitted assets which he had were the proceeds of his own funds — not stolen funds.

If it should be finally held that the burden is upon Appellant to show that the funds which were in his accounts when the premium checks cleared were Brown's and not stolen moneys, that burden has been met by the stipulated evidence which details the items which were in his accounts at the time the checks cleared — not one of which can be claimed to be stolen funds or the proceeds of stolen funds.

It has never been held that all a beneficiary must do in order to trace trust funds is to show that the trustee failed to deliver up the trust estate. A beneficiary is not entitled to touch anything left by the trustee in the absence of evidence tracing the fund. The rule contended for would permit the confiscation of everything the trustee owned even though acquired with his own funds.

Nothing short of placing the burden of proof upon Appellant can sustain the trial court's opinion. The only issue for this court to decide on this point is whether the beneficiary has the obligation of tracing the trust funds before trust property or the proceeds of trust property can be recovered. If tracing is required (and it has been required in every reported case), then F.D.I.C.'s claim to the proceeds must fail. The trial court itself held that stolen moneys were not traced into the accounts and, in fact, they were not traced into anything that Brown had at the time of his death. The judgment awarding F.D.I.C. the proceeds of the policies must be reversed and the fund awarded to Appellant.

F.D.I.C.'S THEORY OF AUTOMATIC SETOFF

A careful examination of Appellee's brief fails to disclose any case supporting its theory of automatic setoff, which would extinguish the balances in Brown's accounts at the time the premium checks cleared. *McConnell v. Henochsberg* was the only case relied upon by the trial court. It is clearly distinguishable as we have pointed out in our opening brief and no other case supporting the theory exists or has been brought forth.

It is only necessary to examine the consequences which would follow the establishment of a theory of automatic setoff in order to demonstrate that it cannot exist.

If it be assumed that everything which Brown himself owned and deposited in his accounts could be thus extin-

guished, F.D.I.C. could recover from every single person who ever accepted a check from Brown on any of his accounts in the Bank. Even though Brown purchased groceries by drawing a check against his bank account when admittedly only his own funds were in the account, F.D.I.C. could require the grocer to pay back the amount received.

The doctor, the lawyer, the druggist and every other person would be subject to being deprived of payment made to them for services performed and everything Brown himself owned could be confiscated to offset the claim for moneys stolen by him from the Bank.

No one could ever accept any check from any bank employee without being liable to return the funds so received should it at some later date develop that the bank employee had stolen some bank funds. The negotiability of checks would be destroyed.

Such a theory has never been announced before — it cannot be accepted and affirmed by this court. The very essence of following trust funds is to trace them into the property sought to be charged with the trust. If automatic setoff were adopted, not only would tracing be not required but even property admittedly free from any taint of trust could be recovered to offset the wrongful depletion of the trust fund.

Every single case recognizes the right of the trustee to have and use his own funds. If automatic setoff were adopted, every decided case would be overruled and a theory

permitting the confiscation of a trustee's own funds to replace stolen trust funds would be substituted.

The complete absence of evidence tracing even one cent of embezzled funds into Brown's bank accounts cannot be held to furnish the foundation for a recovery in favor of F.D.I.C.

FEDERAL PUBLIC POLICY

F.D.I.C. argues that Appellant is estopped to claim that the funds in Brown's bank accounts at the time the checks in payment of the premiums cleared were his own funds. The agreed facts establish that the funds in Brown's accounts when the premium checks cleared were his own. F.D.I.C. may not rely upon Federal Public Policy to confiscate Brown's own property acquired with his own funds.

The public policy which governs this case has been established for centuries in the rule which requires a beneficiary to actually trace trust moneys into property sought to be recovered for the trust fund. No policy exists which would warrant the establishment of a rule which would excuse a beneficiary from tracing trust funds when the trusee is dead.

F.D.I.C. is free to recover every single penny of stolen funds to reimburse itself. It is not entitled to one cent of Brown's own funds to offset its loss. Whenever trust funds can be traced into property or bank accounts, F.D.I.C. is entitled to recover. In this case, since not one cent of embezzled funds was traced into Brown's bank accounts or into the premium payments, F.D.I.C. is not entitled to recover.

APPELLEE'S ARGUMENT UNDER SPECIFICATION OF ERROR III

Our position in connection with this Specification is adequately presented in our opening brief. The question whether any indebtedness exists is not one which is subject to argument or debate. An audit of the books will be conclusive on the question. Since it affects the whole basis of the trial court's holding, Appellant is entitled to have the decision rest upon the true facts.

CONCLUSION

F.D.I.C. has failed to distinguish any of the cases relied upon by Appellant on this appeal. The judgment should be reversed and the fund in the registry of the court awarded to Appellant.

Respectfully submitted,

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